No. 774

IN THE

Supreme Court of the United States

OCTOBER TERM, 1948

THE PITTSBURGH & WEST VIRGINIA RAILWAY COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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CITATIONS

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October Term, 1948

The Pittsburgh & West Virginia Railway Company,
Petitioner

v.

Commissioner of Internal Revenue

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Pittsburgh & West Virginia Railway Company, petitioner above-named, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in this case.

OPINIONS BELOW

The findings of fact and opinion of The Tax Court of the United States (R. 5a-9a) are reported at 9 T.C. 268. The Opinion of the Court of Appeals (R. 11-21) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on February 9, 1949 (R. 22). The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254(1).

QUESTION PRESENTED

Whether petitioner realized taxable income in the taxable years 1941 and 1942 when it purchased its own first mortgage bonds at a cost less than the issue price, where, by the terms of a junior note indenture, petitioner was required to make such purchases of bonds for deposit with the junior note indenture trustee as additional collateral for the junior note issue.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved may be found in the Appendix, *infra*, pp. 13, 14.

STATEMENT

The facts with respect to the issue herein involved as found by The Tax Court (R. 6a-8a) and as contained in Exhibit 3-C before The Tax Court[1] are substantially as follows:

Petitioner is a corporation organized under the laws of Pennsylvania and West Virginia for the purpose of operating a steam railroad. Its principal office is in Pittsburgh. Its tax returns for the years involved were filed with the collector for the 23rd district of Pennsylvania (R. 6a).

On July 1, 1940, petitioner borrowed $7,400,000 and issued its five-year 4 percent notes in such amount. secured by an indenture dated July 1, 1940, between petitioner and First National Bank of Pittsburgh as trustee (R. 6a).

Under the terms of the indenture, petitioner was required during the calendar year 1941 to devote not less

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[1] Petitioner and respondent stipulated in the Court of Appeals that the indenture securing petitioner's junior note issue, Exhibit 3-C before The Tax Court, might be omitted from the printed appendix to the government's brief but that both parties might nevertheless refer thereto in their briefs and in the argument. Copies of this exhibit have been filed with the Clerk of this Court with the printed record. The indenture will be referred to herein as "Exh. 3-C" with appropriate page reference thereto.

than 25 percent of its "Available Net Income" for 1940 and during each calendar year thereafter, so long as any of the notes were outstanding and unpaid, not less than 50 percent of its "Available Net Income" for the preceding year "to the purchase at the lowest price or prices available in the open market but not exceeding the principal amounts thereof" of its then outstanding Series A, B, and C first mortgage 4½ percent bonds, and the petitioner covenanted and agreed that "any and all of such bonds so purchased by the Company [Petitioner] shall remain alive and forthwith be delivered to and pledged with the Trustee to be held by the Trustee as Pledged Securities under and subject to the terms of this Indenture" (R. 6a-7a; Exh. 3-C, pp. 30-34).

If any described event of default were to occur, the trustee was given discretion to convert into money at public sale any of the pledged securities (R. 7a; Exh. 3-C, p. 52). Also under the terms of the indenture, except as otherwise specifically provided, the trustee, in respect of the pledged securities was given for all purposes, whether before or after the happening of an event of default, and could exercise, all the rights of holder and owner and could take any action or proceeding which the holder or owner for value might or could take. In case any sum should be payable on account of the principal of any of the pledged bonds, petitioner covenanted and agreed to pay such sum to the trustee to be held by it as part of the security for the outstanding notes (Exh. 3-C, pp. 55, 26).

Pursuant to the provisions of the indenture petitioner, in the year 1941, purchased \$550,000 face value of its Series A, B, and C first mortgage 4½ percent bonds for the sum of \$349,220, and in the year 1942 purchased \$282,000 face value of such bonds for the sum of \$159,-271.25 and immediately upon such purchases delivered the bonds so purchased to, and pledged them with, the trustee

under the indenture. The bonds remained pledged with the trustee until June 28, 1945, when they were returned to petitioner by the trustee upon the payment of petitioner's five-year 4 percent notes (R. 7a).

The first mortgage bonds were secured by an indenture of mortgage and supplemental indentures between petitioner and The Union Trust Company of Cleveland, Ohio, and Robert S. Crawford, as trustees, dated December 1, 1928, April 1, 1929, April 30, 1929, and April 1, 1930, covering all properties owned or which should subsequently be acquired by petitioner, except cash, accounts receivable, bills receivable, stocks, bonds, notes and similar intangible property and such of the real estate of petitioner as is not included within its rights of way and real estate upon which no structures used for railroad purposes are located, and engines, tenders, cars and other rolling stock (R. 7a-8a).

Respondent included in petitioner's gross income for the years 1941 and 1942 the difference between the face value and the purchase price of its bonds purchased and pledged by petitioner as aforesaid (R. 8a). The Tax Court held that petitioner derived no income in 1941 and 1942 as a result of the purchases and concurrent pledges, being of the opinion that the obligation embodied in the bonds remained alive, that petitioner did not in reality obtain a cancellation of its debt and did not effectively free any part of the mortgaged assets from the continuing lien of the bonds (R. 8a-9a). The Court of Appeals reversed the Tax Court and, disregarding the concurrent pledge of the bonds pursuant to the indenture, held that as a consequence of the *purchase* there was a freeing of petitioner's assets equivalent in amount to the par value of the repurchased bonds and an increase of net assets sufficient to bring the case within the rule of *United States v. Kirby Lumber Co.,* 284 U.S. 1 (1931), and similar decisions (R. 15-21).

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

1. In holding that the petitioner realized taxable income upon the purchase of its own obligations for less than face value when the petitioner did not, in the year of purchase, discharge its liability on the bonds or acquire the right to do so at will.

2. In disregarding the pledge of the purchased bonds as required by the junior note indenture.

3. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. This case presents an important new question not previously decided by this Court involving the taxability of the acquisition of its obligations by a debtor for less than face value. The decision of the Court of Appeals in this case represents an extension of the Kirby rule[2] which conflicts with the basis upon which that rule rests.

Under the Kirby rule a solvent taxpayer realizes taxable income upon the purchase of his own obligations for less than face value if he thereby discharges, or enables himself to discharge at will, his liability to pay them.[3]

The Kirby rule did not change the established principle that no taxable income results from the purchase of property at its market price. Taxable income is realized when the property is subsequently disposed of in such a way that the taxpayer secures to himself the economic gain made possible by the purchase. The *Kirby* case and those following it simply establish the proposition that where a taxpayer purchases his own bonds at a discount and discharges his liability on them, or acquires the right to do so at his election, such discharge or right to dis-

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[2] *U. S.* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931).

[3] *U. S.* v. *Kirby Lumber Co.*, *supra; Helvering* v. *American Chicle Co.*, 291 U. S. 426 (1934); *Commissioner* v. *Jacobson*, 336 U. S. 28 (1949).

charge constitutes a taxable disposition even though the gain thus secured arises from the reduction of a liability rather than from the receipt of money or property. These cases have not qualified the requirement of realization as a condition to the taxation of income. They are in no way inconsistent with the earlier and frequently quoted statement of this Court in *North American Oil Consolidated* v. *Burnet* to the effect that a taxpayer is "not required * * * to report as income an amount which it might never receive."[4]

The present case involves a situation where the requirement of realization of income in the taxable year was not met. Here the petitioner (hereinafter called the taxpayer) did not discharge or acquire the right to discharge its obligations in the year of purchase. Indeed, it could not be said at any time during the taxable year whether or not the taxpayer would ever acquire the right to discharge the bonds without a further outlay of capital.

The taxpayer purchased the bonds in question, in accordance with the requirements of a junior note indenture, for deposit with the junior note trustee as additional collateral (R. 7a). Under the indenture bonds so purchased remained alive and the trustee held them with all the rights of a holder or owner including the right to take any action which a holder or owner could take (R. 7a; Exh. 3-C, p. 55).[5] In the event of a default with respect to the notes the trustee was authorized to sell the pledged securities (R. 7a). If the bonds were thus resold for less than face value, the prospective gain would be proportionately reduced, and it would be possible for the taxpayer to sustain a loss rather than derive a gain as a

[4] 286 U. S. 417, 423 (1932).

[5] The indenture provided that in the absence of default the taxpayer should receive current interest and dividends on all securities deposited as collateral and, accordingly, the trustee was denied the right to collect the interest on the present bonds.

result of the purchase and eventual discharge of its liability on the bonds.[6]

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[6] To illustrate:

Assume that the taxpayer issued one $100 bond and one $100 note at par. Assume that the taxpayer repurchased the bond for $80 and pledged it with the note trustee. Assume, further that upon default in the note indenture the trustee resells the bond for:

(A) $90, (B) $80, (C) $70.

The varying economic gain or loss to be realized by the taxpayer from its repurchase of the bond may be tabulated as follows:

Case A: Pledged Bond Resold by Trustee for $90.

RECEIVED BY TAXPAYER			
On original issuance of bond	$100		
On original issuance of note	100	$200	
EXPENDED BY TAXPAYER			
On repurchase of bond	$ 80		
On redemption of bond after resale by trustee	100		
On redemption of note	10	190	
($90 received by trustee on resale of bond credited on payment of note)			
GAIN			$10

Case B: Pledged Bond Resold by Trustee for $80.

RECEIVED BY TAXPAYER			
On original issuance of bond	$100		
On original issuance of note	100	$200	
EXPENDED BY TAXPAYER			
On repurchase of bond	$ 80		
On redemption of bond after resale by trustee	100		
On redemption of note	20	200	
($80 received by trustee on resale of bond credited on payment of note)			
GAIN			0

Case C: Pledged Bond Resold by Trustee for $70.

RECEIVED BY TAXPAYER			
On original issuance of bond	$100		
On original issuance of note	100	$200	
EXPENDED BY TAXPAYER			
On repurchase of bond	$ 80		
On redemption of bond after resale by trustee	100		
On redemption of note	30	210	
($70 received by trustee on resale of bond credited on payment of note)			
Loss			*$10*

The gain or loss in each case above is the index of economic benefit or detriment enjoyed or suffered by the taxpayer from the purchase of the bond. It is that figure which tests the extent to which the purchase resulted in a "freeing" of the taxpayer's assets.

Under the decision of the Court of Appeals a tax would be imposed in each case on a $20 "gain" on the purchase of the bond, although, as illustrated above, there might be a loss on the transaction, which could not occur but for the purchase of the bond.

It is apparent that the taxpayer, when it made the purchases here in question, did not discharge its bonds or acquire the right to discharge them at will. Immediately upon the purchase of the bonds by the taxpayer the trustee acquired an interest in them enforceable against the taxpayer if it had attempted to cancel the bonds contrary to its obligation under the indenture.[7] Indeed, the trustee could have had the aid of a court of equity to compel the taxpayer to purchase the bonds and deliver them to it.[8] It follows that at no time prior to the return of the bonds by the trustee upon payment of the notes did the taxpayer acquire the right to discharge them.

Under the Kirby rule a tax does not attach to the mere purchase of bonds. It is the further fact of the discharge of the obligation or freedom to discharge it that raises the tax.[9] Therefore, in the present case since the taxpayer did not, in the year of purchase, discharge its bonds or acquire the right to do so at will, the taxable event is lacking. So long as the trustee had the power to sell the bonds, it cannot be said that the taxpayer would ever enjoy any economic gain or release of its assets. To impose a tax would be to require the taxpayer "to report as income an amount which it might never receive."

The decision of the Court of Appeals to impose the tax in this case notwithstanding the absence of the taxable event thus represents an extension of the Kirby rule which conflicts with the very basis upon which the rule is founded.

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[7] American Law Institute, *Restatement of the Law of Security*, §10; *Murdock* v. *Murdock*, 300 Pa. 280, 150 Atl. 599 (1930); *Davis* v. *Billings*, 254 Pa. 574, 99 Atl. 163 (1916).

[8] *Hetzel* v. *Sawyer*, 10 Dist. (Pa.) 29 (1901).

[9] *Commissioner* v. *Jacobson*, *supra*, where this Court said "The respondent realized an immediate financial gain from his purchase of these bonds at a discount. *By that acquisition he was enabled, at will, to cancel them and thus discharge himself from liability to pay them.*" (Italics supplied.)

2. The decision of the Court of Appeals in this case rests upon the theory that the taxpayer became the "owner" of the bonds upon purchase and thereby discharged its liability on the bonds notwithstanding the fact that the bonds were pledged and might be resold by the note trustee in case of default under the note indenture. According to the Court of Appeals the pledge was a separate and unrelated event without significance to the case. "The purchase of the bonds", said the Court of Appeals, "was the identifiable event affecting closed transactions and fixing the realization of income in the taxable years" because upon such purchase there was a "*freeing* of the taxpayer's assets equivalent in amount to the par value of the repurchased mortgage bonds" (R. 21).

It is submitted that this theory is erroneous. The pledge of the bonds cannot be ignored. It deprived the taxpayer of the power to discharge its liability on the bonds, which, as was pointed out above, is the significant taxable event. The taxpayer's "ownership" of the bonds is material in this case only as it carries with it the power to discharge the liability represented by the bonds, and thereby enjoy the economic benefits to be derived from the release of its assets. The view of the Court of Appeals that the taxpayer had such "ownership" as carried with it this power conflicts in principle not only with the decisions of the Pennsylvania Courts[10] but also the decisions of other Courts of Appeal.[11]

The holding of the Court of Appeals that the taxpayer realized gain upon the purchase of its bonds not-

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[10] *Murdock* v. *Murdock*, 300 Pa. 280, 150 Atl. 599 (1930); *Davis* v. *Billings*, 254 Pa. 574, 99 Atl. 163 (1916); *Hetzel* v. *Sawyer*, 10 Dist. (Pa.) 29 (1901).

[11] *In re Chicago & N. W. Ry. Co.*, 35 F. Supp. 230 (N. D. Ill., 1940); aff'd. 126 F. (2d) 351 (C.C.A. 7th, 1942); *Burrowes* v. *Nimocks*, 35 F. (2d) 152 (C.C.A. 4th, 1929); *Gage Lumber Company* v. *McEldowney*, 207 Fed. 255 (C.C.A. 6th, 1913).

withstanding the fact that the right to discharge the liability depended upon the taxpayer's subsequent fulfillment of its obligations under the note indenture is in conflict with the principle which governed the decision of the Court of Appeals for the Fifth Circuit in *Walker v. Commissioner*.[12] In the *Walker* case the holders of notes of a partnership of which the taxpayer was a member agreed to forgive a part of the indebtedness on condition that the partnership first pay off the balance of indebtedness less the amount to be forgiven. The partnership paid the balance of indebtedness and the agreed portion was forgiven. The question then arose whether the taxpayer's share of the forgiven portion of indebtedness constituted taxable income in the year of the original agreement or in the later year when the partnership complied with the condition imposed by the agreement. The Court of Appeals for the Fifth Circuit held that the income was realized in the later year, adopting the Commissioner's contention that the agreement for the forgiveness of indebtedness with a condition attached could not give rise to taxable income until the condition was fulfilled.[13]

The decision of the Court of Appeals in the present case also conflicts in principle with the decision of the Court of Appeals for the Sixth Circuit in *Commissioner v. Cleveland Trinidad Paving Co.*[14] It was there held that amounts earned by a taxpayer as compensation for services, but which were temporarily withheld by the payor as a guarantee fund, were not taxable until the guarantee had expired. The Court observed that the taxpayer's right to the amounts withheld was merely contingent as long as the guarantee was in force. Similarly in the

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[12] 88 F. (2d) 170 (C.C.A. 5th, 1937), cert. den. 302 U.S. 692 (1937).

[13] The court's opinion indicates that the partnership was insolvent in the earlier year, but no significance is attached to this fact in the holding.

[14] 62 F. (2d) 85 (C.C.A. 6th, 1932).

present case, where it is the discharge of the liability represented by the repurchased bonds which produces taxable income, there could be no realization of income so long as the taxpayer had no right to discharge the liability and enjoy the gain to be derived therefrom.

3. Junior financing of the sort here involved is not uncommon, particularly in situations involving loans from the Reconstruction Finance Corporation. The issue presented in the present case will arise in other cases. In fact the same question is now presented in a petition before the Tax Court involving asserted income of approximately $2,000,000. *Illinois Central Railroad Company* v. *Commissioner*, Tax Court Docket No. 19494.

CONCLUSION

The taxpayer submits that the question is of such importance as to warrant review by this Court and this petition for a writ or certiorari should be granted.

Respectfully submitted,

W. A. Seifert,

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Norman D. Keller,

Attorneys for Petitioner.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever. * * *

* * * * * * *

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)-14. CANCELLATION OF INDEBTEDNESS.

(a) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. * * * A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See section 19.22 (a)-18.) * * *

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SEC. 19.22 (a)-18. SALE AND PURCHASE BY CORPORATION OF ITS BONDS.—(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (*c*) If, however,

the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

* * * * * * *

Section 29.22 (a)-13 and 29.22 (a)-17 of Treasury Regulations 111, promulgated under the Internal Revenue Code, applicable to the year 1942 herein, contained provisions identical with those of Sections 19.22 (a)-14 and 19.22 (a)-18, respectively, above quoted.

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CITATIONS

In the Supreme Court of the United States

October Term, 1948

No. 774

The Pittsburgh & West Virginia Railway Company, petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 5-9) are reported at 9 T. C. 268. The opinion of the Court of Appeals (R. 11-21) has not yet been reported.

JURISDICTION

The judgment of the Court of Appeals was entered on February 9, 1949. (R. 22.) The petition

for a writ of certiorari was filed on May 9, 1949. The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTION PRESENTED

During the taxable years 1941 and 1942, the taxpayer purchased its own first mortgage bonds at a cost less than the face value of the obligations. Upon acquiring the bonds, the taxpayer pledged them as security for a subsequent and different note issue.

Was the Court of Appeals correct in holding that the taxpayer realized taxable income in 1941 and 1942 when it increased its net assets by purchasing the first mortgage bonds at a cost less than their face value?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 10-11.

STATEMENT

The facts in this case were stipulated (R. 3-5), and were found by the Tax Court as stipulated (R. 6). The taxpayer corporation was organized under the laws of Pennsylvania and West Virginia, and had its principal office in Pittsburgh, Pennsylvania. (R. 6.) It had outstanding certain first mortgage, 4½ percent bonds, series A, B, and C, which were secured by an indenture and supplemental indentures of mortgage dated December 1, 1928, April 1, 1929, April 30, 1929, and April 1,

1930, covering all property (with certain exceptions) then owned or subsequently acquired by the taxpayer. (R. 7-8.)

Later, on July 1, 1940, the taxpayer borrowed $7,400,000 and issued 5-year 4 percent notes secured by an indenture which, among other things, required the taxpayer in each year to utilize a certain percentage of its "Available Net Income" to purchase its outstanding mortgage bonds and to deliver them to the trustee named in the note indenture to be held with other pledged securities subject to the terms of the indenture. If there was a default under the note issue, the trustee was authorized to sell any of the pledged securities, including the mortgage bonds, at public sale. (R. 6-7.) During the time that the mortgage bonds were held in pledge, the taxpayer had no obligation to pay any interest on the bonds to the trustee. (R. 21.)

In the taxable year 1941, the taxpayer purchased $550,000, face value, of the first mortgage bonds for the sum of $349,220, and in the taxable year 1942 it purchased $282,000, face value, of such bonds for the sum of $159,271.25. After the bonds were purchased, they were pledged in accordance with the note indenture, and remained in pledge until June 28, 1945, when they were returned to the taxpayer upon the payment of its notes. (R. 7.)

The Commissioner included in the taxpayer's gross income for the years 1941 and 1942 the difference between the face value of the bonds and the

purchase price paid by the taxpayer. (R. 8.) The Tax Court refused to uphold the Commissioner's determination. (R. 8-9.) On the Commissioner's petition for review, the Court of Appeals reversed, holding that the Commissioner's determination should have been sustained. (R. 11-21.)

ARGUMENT

1. The decision below is correct. When the taxpayer corporation, during the taxable years 1941 and 1942, purchased its own first mortgage bonds at less than face value, it thereby became enriched to the extent that the face amount of the obligations so acquired exceeded the purchase price, and it thereby realized income taxable under Section 22 (a) of the Internal Revenue Code (Appendix, *infra*).* *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *American Chicle Co.*, 291 U. S. 426; *Commissioner* v. *Jacobson*, 336 U. S. 28; Section 19.22 (a)-18, Treasury Regulations 103 (Appendix, *infra*). While the bonds were not retired or cancelled by the taxpayer when they were acquired, there was an immediate decrease in the amount of its outstanding indebtedness which, being greater than the value of the assets used to achieve the reduction, resulted in an increment in net worth and the realization of taxable gain. The failure to retire or cancel the obligations did not prevent the gain from being realized in the taxable years when the bonds were acquired by the tax-

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* So far as the record discloses, the bonds were originally issued at face value.

payer. This was the holding of the *Jacobson* case, *supra* (p. 38), where the reacquired bonds were held "intact" by the taxpayer and, ever since Article 22 (a)-18 (1) (c), Treasury Regulations 86, promulgated under the Revenue Act of 1934, the applicable Treasury Regulations have consistently omitted the requirement of previous Regulations that a taxpayer corporation retire its own obligations, and necessitate that the gain be taxed in the year when the obligations are reacquired. In view of the *Jacobson* decision, it is plain that the Regulations express the correct interpretation of the broad scope of Section 22 (a) of the Internal Revenue Code. See *Central Paper Co.* v. *Commissioner,* 158 F. 2d 131 (C. A. 6th); *Tennessee Consol. Coal Co.* v. *Commissioner,* 145 F. 2d 631, 633-634 (C. A. 6th); *Montana, Wyoming & Southern R. Co.* v. *Commissioner,* 77 F. 2d 1007 (C. A. 3d), certiorari denied, 296 U. S. 604; *Garland Coal & Mining Co.* v. *Helvering,* 75 F. 2d 663 (C. A. D. C.).

The taxpayer attempts to escape this result by contending that there was no realization of gain during the taxable years because the bonds, immediately following their acquisition, were pledged as additional security for certain notes, in accordance with the terms of the indenture securing those notes. (Pet. 5-9.) These notes, it should be noted, represented a subsequent indebtedness of the taxpayer quite independent of and not related to its obligation on the mortgage bonds which were purchased during the taxable years. The taxpayer

argues, apparently, that gain on the reacquired mortgage bonds could not be realized while they remained pledged to secure the note issue.

Since the agreement to pledge the bonds was undertaken in connection with an altogether different transaction, the court below was entirely correct in rejecting the taxpayer's attempt to amalgamate these two unrelated matters, and in holding that the determination of gain would not have to (R. 16) "await the outcome of the pledging transaction with the note indenture trustee * * *." When the taxpayer repurchased its bonds from the bondholders at a discount, it was no longer indebted to them, there was a decrease in its total liabilities and, to the extent of the discount, there was a corresponding increase in the taxpayer's net assets immediately upon the acquisition and there was a realization of taxable gain at that time. The resulting income, under well settled principles of annual accounting, was required to be taxed in the years when the taxpayer received the gain. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. The pledging of the bonds to secure the note issue did not have the effect of increasing anew the taxpayer's outstanding indebtedness for it is undeniable, as the court below observed (R. 18), that the total obligation to the noteholders remained the same after the pledge as it had been before. The taxpayer acquired the mortgage bonds as an owner; it pledged them as an owner; it continued to remain the owner

while they were pledged; it had no obligation, not even that of paying interest, so long as the pledge continued. Cf. *Commissioner* v. *Jacobson,* 336 U. S. 28, 38. The fact that the taxpayer, by reason of the pledge, had voluntarily deprived itself of the authority to cancel or retire the bonds immediately (Pet. 9-10), does not affect the matter since they did not represent an outstanding obligation while they were held in pledge. There is, accordingly, no reason why the gain enjoyed by the taxpayer at the time when it increased its net assets should be postponed from taxation until the bonds were released from pledge.

It is true that if the taxpayer should have subsequently defaulted on the notes the trustee would have been empowered to resort to the security afforded under the note indenture, including the authority to sell the mortgage bonds; this would have had the effect of renewing the taxpayer's obligation on the bonds. However, even though it were possible that the taxpayer's total indebtedness might be increased in the future because of a separate and distinct transaction, and that the gains achieved by the taxpayer during the taxable years when it repurchased the mortgage bonds might be diminished or erased in a subsequent tax year as a consequence of this unrelated transaction, it would not follow that the gains should go untaxed in the years when they in fact occurred. Cf. *Burnet* v. *Sanford & Brooks Co., supra,* pp. 364-366; *Helvering* v. *Bruun,* 309 U. S. 461, 467; *Helvering*

v. *American Chicle Co.,* 291 U. S. 426, 430; *North American Oil* v. *Burnet,* 286 U. S. 417, 424.

2. There is no conflict of decisions. *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, rests on the principle that taxable gain is realized when the debtor's net assets are increased because of a reduction of outstanding obligations accomplished by a lesser expenditure. Since such an increase took place in the taxable years here involved, the holding below follows the *Kirby Lumber Co.* decision and does not (Pet. 5-6) conflict with the rule of that case. The other decisions relied on by the taxpayer (Pet. 10-11), *Walker* v. *Commissioner,* 88 F. 2d 170 (C. A. 5th), certiorari denied, 302 U. S. 692, and *Commissioner* v. *Cleveland Trinidad Pav. Co.,* 62 F. 2d 85 (C. A. 6th), are similarly not opposed to the decision of the court below. In the *Walker* case it was held that the gain was taxable in the year when the taxpayer's net assets were increased by a reduction of indebtedness, and not in an earlier year when the parties had agreed to settle the indebtedness in the future. The decision in the *Walker* case is thus in harmony with the decision here where the gain is also being taxed in the years when the taxpayer's outstanding liabilities were decreased and its net assets increased. The *Cleveland Trinidad Pav. Co.* case, holding that a cash basis taxpayer is not in receipt of income until the year in which it is entitled to receive the income, plainly has no bearing on the issues here presented.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

Philip B. Perlman,
Solicitor General.
Theron Lamar Caudle,
Assistant Attorney General.
Ellis N. Slack,
Hilbert P. Zarky,
Special Assistants to the Attorney General.

June 1949.

APPENDIX

Internal Revenue Code:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
(26 U. S. C. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.22(a)–14. *Cancellation of indebtedness.*—(*a*) *In General.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See section 19.22(a)–18.) * * *

Sec. 19.22(a)–18. *Sale and purchase by corporation of its bonds.*—(1) (*a*) If bonds are

issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

* * * *

Sections 29.22(a)-13 and 29.22(a)-17, Treasury Regulations 111, promulgated under the Internal Revenue Code and applicable to the taxable year 1942, contain provisions which are identical with those of Section 19.22(a)-14 and 19.22(a)-18 of Treasury Regulations 103 set forth above.

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